Moreover and despite the BOCs' refrains that ARMIS rates-of-return are not ideal due to certain misallocations, that "does not affect the overall integrity of *trends* in the data, *since those (arguable) misallocations do not change from period to period.*"[43] Stated differently, "even if the absolute rate of return developed for the special access category using ARMIS data is off by some percentage, *the trend in the data (in this case steadily up [as shown above]) ...[is] a reliable indicator of the BOCs' ability to increase prices to supracompetitive levels without fear of attracting competitive entry.*"[44]

Ratepayers and the public at large are harmed by funding the BOCs' supracompetive profits, paying astronomical special access rates or increased retail rates for services (such as wireless telephone service) that rely on special access services. A comparison of year-end 2003 data with the FCC's most recently authorized return level for interstate service of 11.25 percent reveals that excessive special access charges resulted in overcharges equal to $5.5 billion, which otherwise means that BOCs were overcharging special access ratepayers $15 million per day.[45] During 2004, the BOCs' excessive overcharges went up 15 percent - the BOCs' overcharges yielded a whopping $6.4 billion in excessive special access revenues or $17.5 million per day.[46] From 2004 to 2006, the BOCs' overcharges skyrocketed by an astonishing 30 percent - *the*

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43 ETI White Paper at 29.

44 ETI White Paper at 29 (emphasis added).

45 ETI White Paper at 7-8 Table 1.1; Ad Hoc 6/13/05 Declaration of Susan M. Gately, ¶ 6.

46 Ad Hoc 6/13/05 Declaration of Susan Gately, ¶ 6.

BOCs' overcharges yielded an incredible $8.31 billion in excessive special access revenues or $22.77 million in overcharges per day in 2006.[47]

Updated Table 2
2006 RBOC Overcharges

		Calculation		Total Interstate		Special Access
1	Average Net Investment		$	24,866,133,000	$	7,579,276,000
2	Net Return		$	6,497,614,000	$	5,901,062,000
3	ROR	Line1/Line 2	$	26.13%	$	77.86%
4	Approved ROR	11.25%	$	11.25%	$	11.25%
5	Tax Rate	39.25%	$	39.25%	$	39.25%
6	Overearnings	(Line 3-Line 4)*Line 1	$	3,700,177,075.00	$	5,048,391,575
7	Overcharging	Line 6/(1-Line 5)	$	6,090,826,461	$	**8,310,109,558**
8	Daily Overcharges	Line 7 / 365	$	16,687,196	$	22,767,424

Sources: Federal Communications Commission, ARMIS Report 43-04, Access Report: Table 1, Cost and Revenue YE 2006. Available at http://svartifoss2.fcc.gov/eafs7/adhoc/table_year_tab.cfm?reportType=4304 (accessed Aug. 2, 2007). 39.25% is the composite tax rate currently used in the FCC's HCPM/HAI Synthesis Cost Proxy Model. http://www.fcc.gov/wcb/tapd/hcpm/welcome.html

Nor are the BOCs' special access prices lawful. The United States Supreme Court and lower courts have consistently held that where "returns have greatly exceeded a fair percentage of return upon a fair base, it follows as a matter of law that the rates charged . . ., instead of being 'just and reasonable' ...[are] excessive."[48] The Commission has similarly recognized that only firms with market power can expect to consistently earn profits that greatly exceed economic profits.[49]

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47 This Table 2 is based on Table 1.1 of Ad Hoc 6/13/05 Declaration of Susan M. Gately and updated to reflect 2006 figures.

48 *Potomac Elec. Power Co. v. Public Utils. Comm'n of the District of Columbia*, 158 F.2d 521, 523 (D.C. Cir. 1947) (citing and quoting *Dayton-Goose Creek Co. v. United States*, 263 U.S. 456, 483 (1924) ("If the profit is fair, the sum of the rates is so. If the profit is excessive, the sum of the rates is so").

49 *Local Competition Order*, ¶ 700 ("Normal profit is embodied in forward-looking costs because the forward-looking cost of capital, i.e., the cost of obtaining debt and equity financing,

At bottom, the foregoing demonstrates that the Commission's special access pricing rules are not working and permit the BOCs to charge monopolistic rates. When the price cap regime was implemented, the Commission made clear that observed returns remain the litmus test for determining whether the specific price cap rules are working to protect consumers from unjust and unreasonable rates or if the rules need to be overhauled. In fact, the Commission stated that a "price cap approach cannot free carriers to earn excessive [supracompetitive] profits in light of their costs."[50] It further emphasized that its price cap regime would include "ongoing monitoring" and that a future "comprehensive review" of the price cap mechanism would "focus prominently on the carrier costs and profits."[51] Accordingly, the BOCs' supracompetitive rates-of-return further demonstrates that special access prices are unreasonable and that the Commission's regulatory framework governing interstate special access is fatally flawed and in dire need of reform.

B. Verizon's Pricing for FiOS Service Shows that Special Access Pricing Is Above Cost Plus a Reasonable Rate of Return

It is clear from the disparity in rates for special access and other comparable technologies that the BOCs are extracting monopoly rents from their special access services. For example, Verizon offers 5 Mbps / 2 Mbps FiOS to small businesses at a rate of $99.99 dollars per month

is one of the forward-looking costs of providing network elements"); Horizontal Merger Guidelines, U.S. Department of Justice and the Federal Trade Commission (issued 1992, revised 1997) ("Market power to a seller is the ability to profitability to maintain prices above competitive levels for a significant period of time").

[50] *AT&T Price Cap Order,* 4 FCC Rcd 2873, ¶ 885.

[51] *AT&T Price Cap Order*, 4 FCC Rcd 2873, ¶ 885.

(with a static IP address.)[52] Its DS1 special access offering, at significantly lower speeds, is $197.00.[53] If Verizon is able to charge such low rates for newly deployed, unamortized facilities, this raises questions about why it needs to charge such high rates for lower capacity facilities that are substantially depreciated. Special access facilities that rely on older technologies, such as TDM multiplexing, and have likely been fully depreciated, should be less expensive than Verizon's newly deployed and state-of-the-art high-capacity, fiber-optic FIOS service. At a minimum, a forward-looking cost structure that applies to special access services should result in rates that are no higher than what the BOCs charge for comparable services using newly deployed technology.

[52] Letter from Leora Hochstein, Executive Director, Federal Regulatory, Verizon, to Marlene Dortch, Secretary, FCC at 4 (filed May 11, 2006 in *Implementation of Section 621(a)(1) of the Cable Communications Policy Act of 1984*, MB Docket No. 05-311).

[53] Verizon Tariff F.C.C. No.1 § 7.5.9(A)(1).

C. Additional BOC Mergers Increase the Need for Reform

1. Increased Concentration Facilitates Potential for Harm

As many commenters in this proceeding predicted,[54] the mergers of AT&T with SBC and MCI with Verizon eliminated most of the little competition that existed in the special access market and ensured the BOCs' power to inflate their special access prices. The mergers have also encouraged exclusionary conduct in the special access market and have undermined competition in other markets through monopoly control of critical special access inputs.

Prior to the mergers, AT&T and MCI were the largest competitive suppliers of special access services in the nation,[55] as confirmed by the experience of competitive carriers, such as Sprint and Broadwing, in seeking alternatives to BOCs' facilities.[56] The DOJ found that SBC and AT&T were the only two firms that owned or controlled a direct wireline connection to hundreds of commercial buildings throughout the legacy AT&T footprint and that the merger of SBC and AT&T would effectively eliminate competition for facilities-based special access service to those buildings.[57] It made similar findings in regard to the Verizon - MCI merger.[58] It recognized that because competitive entry is a difficult, time consuming, and expensive process,

[54] *See, e.g.,* BT Americas 6/13/05 Comments at 7-12; Broadwing *et al.* 6/13/05 Comments at 4, 19-22; Sprint 6/13/05 Comments at 7-8; WilTel 6/13/05 Comments at 12-13.

[55] BT Americas 6/13/05 Comments at 7; Declaration of Alfred E. Kahn and William E. Talyor on behalf of BellSouth, Qwest, SBC and Verizon, RM-10593, at 23-24 and Table 14, (filed Dec. 2, 2002).

[56] *See, e.g.,* Broadwing et al. 6/13/05 Comments at 4 & 19 ("The SBC-AT&T and Verizon-MCI mergers will therefore reduce the competitive provision of special access facilities in the SBC and Verizon regions from three potential suppliers to two.").

[57] United States v. SBC Communications, Inc. and AT&T Corp., 1:05CV02102 (EGS), Department of Justice Competitive Impact Statement at 6-7 (D.D.C. filed Nov. 16, 2005).

[58] *See* United States v. Verizon Comms., Inc. and MCI, Inc., No. 1:05CV02103 (HHK), Department of Justice Competitive Impact Statement (D.D.C. filed Nov. 16, 2005).

competitive access providers would typically only build into a particular building after they have secured a customer contract of sufficient size and length to justify the anticipated construction costs for that building. Thus, entry would not be timely, likely, or sufficient to eliminate the competitive harm that would result from SBC's acquisition of AT&T.[59] The Commission itself has also recognized that large fixed and sunk costs, economies of scale, the difficulty of securing rights-of-way, and operational impediments make it unlikely that other competitive carriers will be able to replace the services and facilities that were offered by AT&T and MCI.[60] As predicted, the mergers removed the two largest suppliers of special access from the market.

On the demand side of the equation, AT&T and MCI also exerted some limited market discipline on BOC special access prices by virtue of their large volume of purchases and the threat of extending their own fiber networks to reach some locations.[61] This limited market disciplining effect was lost with the mergers. This shrunken market has suppressed investment in special access services by non-BOC providers, fearful of never recovering huge sunk costs required to compete in the special access market.[62]

Paradoxically, this reduction in demand also reduced the supply of discounted special access services. In addition to constructing their own facilities, AT&T and MCI were two of the very few carriers with sufficient demand to qualify for the highest volume discounts offered by

[59] United States v. SBC Communications, Inc. and AT&T Corp., 1:05CV02102 (EGS), Department of Justice Competitive Impact Statement at 8 (D.D.C. filed Nov. 16, 2005).

[60] *TRRO*, ¶¶ 150-151.

[61] Broadwing *et al.* 6/13/05 Comments at 19-21.

[62] BT Americas 6/13/05 Comments at 10.

the BOCs, which they were able to pass on as resellers. These discounted rates are no longer available to the vast majority of competitive carriers.

Of course, these combined companies are also able to fashion discounts that are uniquely available only to each other. In January 2007, Verizon filed a new contract tariff for which AT&T is likely the only carrier that could qualify.[63] The possibility of this cross-BOC discounting further points to the need for reform of rules governing BOC special access service.

2. Increased Economies of Scale Reduce BOC Costs

The BOCs have consistently touted the efficiencies to be gained from their mergers, but the benefits have not accrued to consumers of special access. In the latest merger, AT&T claimed vertical integration efficiencies flowing from the integration of BellSouth's local exchange network with AT&T's long distance network,[64] and the Commission agreed. It found that "significant benefits are likely to result from the vertical integration of the complementary networks and facilities of AT&T and BellSouth. . . . [T]he combination of their services will benefit large enterprise and wholesale customers by enhancing the merged entity's ability to make available the broad range of communications services and global reach that those customers demand."[65] Using exactly the same boilerplate language, the Commission touted the efficiencies to be gained by the SBC-AT&T merger[66] and the Verizon-MCI merger as well.[67]

[63] Verizon Telephone Companies, Tariff FCC No. 14, Section 21.22 (Contract Tariff Option 21) at 21-171 through 21-191.

[64] AT&T-BellSouth Merger Application, WC Doc. No. 06-74, at 40-46 (filed Mar. 31, 2006).

[65] *AT&T-BellSouth Merger Order*, ¶ 212.

[66] *SBC-AT&T Merger Order*, ¶ 191.

[67] *Verizon-MCI Merger Order*, ¶ 203.

The mergers will increase the merged companies' opportunities to achieve economies of scale and scope and even higher rates-of-return. If even a portion of the efficiencies could be directly assigned to special access costs, the companies will experience considerable special access cost savings through consolidation of management and overhead functions, thus permitting higher rates-of-return for special access. Considering that, as discussed elsewhere in these comments, BOCs were already earning excessive and increasing rates-of-return for special access before the mergers, the increased economies of scale and scope that the mergers permit increase the need for special access reform.

The Commission has also recognized that, even without the merger efficiencies, the telecommunications industry in general and LECs in particular tend to realize productivity gains that are much greater than the economy as a whole. This is the reason that the Commission included an X-factor in the original price cap regime, *i.e.* to reflect these productivity gains in the ILEC cost basis.[68] The current price cap regime, however, does not, in effect, have an X-Factor because under the *CALLS Order* the Commission converted the X-Factor into a transitional mechanism unrelated to productivity that reduced switched access rates to a specific target and lowered special access rates only for a specified period of time.[69] Therefore, at the present time, the X-Factor is equal to zero and all the alleged efficiency gains that BOCs have touted to the Commission as benefits of their various proposed mergers produce no benefit at all for special

[68] *LEC Price Cap Order*, ¶¶ 74-119.

[69] *CALLS Order*, ¶ 140. The special access X-factor was set at 3.0 percent in 2000, 6.5 percent for the next three years, and equal to the GDP-PI thereafter, essentially freezing the special access PCI (after accounting for exogenous cost adjustments) *CALLS Order*, ¶ 149.

access customers. Under the current price cap plan, BOCs are the only beneficiaries of productivity gains.

As discussed later in these comments, to address this shortcoming and to be consistent with the justification given by the Commission in the *LEC Price Cap Order* for use of an X-Factor, the Commission should re-impose a productivity-based X-factor in the price cap formula to ensure that rates continue to decline relative to the measure of inflation, GNP-PI.[70] Although the Commission should, at a minimum, apply the X-factor prospectively, it should also apply it retroactively back to 2004, when the Commission, under the CALLS Plan, effectively eliminated the X-factor and froze the PCI.

3. Larger BOC Footprints Increase Incentive for BOCs to Harm Competitors Through Excessive Pricing of Their Essential Inputs

The Commission has previously recognized that the larger the combined entity, the more incentive it will have to discriminate because of gains from external effects.[71] Before the BOC mergers, discrimination by one BOC against a competitor created anticompetitive spillover benefits for other BOCs in other regions that the discriminating BOC could not share. A merger between the discriminating BOC and another BOC would, however, enable capture of the spillover effect within the merged company. In its *SBC-Ameritech Merger Order*, the Commission explained how this spillover effect works in practice: "[A] merger's big footprint will create more incentives for the merged entity to discriminate against competitors . . . ."[72] The Commission concluded that "the level of discrimination engaged in by the combined entity in

[70] *See LEC Price Cap Order*, ¶ 75.

[71] *SBC-Ameritech Merger Order*, ¶ 209.

[72] *SBC-Ameritech Merger Order*, ¶ 209.

each region within the combined territory would be greater than the sum of the level of discrimination engaged in by the two individual companies in their own, separate regions, absent the merger."[73]

In addition to increasing the combined entity's *incentive* to discriminate, the merger would, if allowed to proceed, also dramatically increase the combined entity's *ability* to discriminate. As the Commission found in the *SBC-Ameritech Order,* "The increased ability of the combined entity to discriminate, at least in the absence of stringent conditions, will result from: (1) the reduction in the number of benchmarks, making it more difficult for regulators to monitor and detect misconduct; (2) the ability of the combined entity to coordinate and rationalize the discriminatory conduct of the two companies (sharing 'worst practices'), making detection and proof of discrimination more difficult; and (3) the efficiencies (economies of scope) that result from being able to share strategies and arguments while fighting similar regulatory battles in multiple state forums."[74] And with the loss of much of the Commission's remaining benchmarking capability, the competitors' ability to prove the existence and extent of discrimination will be severely diminished as well.

Only the temporary merger conditions relating to special access have to a limited extent prevented the BOCs from fully exploiting their "big footprints" and charging ever higher rates for critical inputs, but some of those commitments (i.e. Verizon-MCI) expire next summer, while the others (AT&T-BellSouth) expire June 30, 2010. After these commitments expire, the BOCs would have every incentive and the ability to exploit their increased dominance in the

[73] *SBC-Ameritech Merger Order,* ¶ 193.

[74] *SBC-Ameritech Merger Order,* ¶ 209.

special access market in order to raise the costs of key inputs and engage in a price squeeze against competitors in other markets. By engaging in a price squeeze, Verizon and AT&T will be able to provide their own long distance, wireless and other affiliates with a strategic cost advantage for key special access assets while still obtaining supracompetitive prices for their special access services from other carriers and customers.

4. *The Merger Conditions Have Not Mitigated Harms*

Finally, in case there is any doubt on this issue, the special access merger conditions do not ameliorate the potential for harm from the mergers or eliminate the need for reform in this proceeding because they fail to address the most serious harms. Although the conditions provide for protection against some price increases, they do nothing about the excessive level of current prices. Nor do the conditions limit the ability of BOCs to impose anticompetitive conditions on discounts of the type discussed elsewhere in these comments. In any event, even if the conditions provided a significant benefit, they are generally only in effect for thirty months, ending June 30, 2009 or sooner. Nor do they apply to Qwest or other price cap ILECs. The mergers therefore heighten the need for special access reform. Nor do the merger conditions mitigate the reduced ability of regulators to detect and correct anticompetitive conduct in provision of special access service caused by eliminating SBC and BellSouth as independent benchmarks by which to judge other ILECs.

D. BOCs Continue to Possess a Bottleneck

As noted, the current record shows that CLECs are dependent on BOC services for access to up to 95% of customer locations. Recent experience confirms that BOCs continue to possess bottleneck control over access to the vast majority of customer locations. The DOJ concluded in connection with its review of the SBC/AT&T and Verizon/MCI mergers that "for the vast majority of commercial buildings" in their territory, SBC and Verizon are the only carriers that owns a last-mile connection to the building,[75] that CLECs have built or acquired their own last-mile fiber optic connections for only a "small percentage of commercial buildings,"[76] and that SBC and Verizon are the "dominant" providers "of Local Private Lines (special access)" in their service areas.[77] The DOJ's analysis by itself is dispositive of any issue of whether BOCs continue to control bottleneck access to customer locations. And, it is worth noting that BOCs' control of access to customer locations only became worse after the mergers because the DOJ did not require SBC and Verizon, respectively, to divest most AT&T and Verizon circuits. The recent GAO report, discussed in later sections of these comments, also found that competitive alternatives exist in only a small set of buildings.[78] The DOJ and GAO analyses are consistent with the Commission's determinations in the *TRRO* and *TRO* that CLECs are impaired in their ability to serve nearly all business customer locations with out unbundled access to DS1 and DS3 loops and that CLECs are impaired in their ability to provide both narrowband and broadband services without unbundled access to copper loops.[79]

In addition, since initial comments were filed, the Commission had occasion to review the availability of wholesale alternatives to ILEC last mile access in the Omaha, Nebraska MSA.

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[75] DOJ Complaint, USA v. SBC Communications and AT&T Corp., Civil Action No. 1:05CV02102, USDC, ¶ 15; DOJ Complaint, USA v. Verizon Communications, Inc. and MCI, Inc., Civil Action No. 1:05CV02102, ¶ 15.

[76] *Id.*, ¶16.

[77] *Id.*, ¶ 20.

[78] GAO Report at 12 & 19.

[79] *See, e.g., TRRO,* ¶¶ 174, 178; *TRO*, ¶ 248.

The Commission concluded that Qwest was the only provider of wholesale access there.[80] This also shows illustrates that, even in major markets, there are rarely if ever alternatives to BOC last mile facilities.

Apart from these evaluations by regulators, CLECs' experience continues to affirm that there are no realistic alternatives to BOC facilities for access to most customers. The attached declarations of Deltacom, Inc., McLeodUSA Telecommunications Services, Inc., and Penn Telecom, Inc. show that CLECs remain dependent on BOC UNEs or special access in order to provide service to the vast majority of their customers. As explained in those declarations, it is rarely economically feasible for competitive carriers to construct loops at the DS0, DS1, or DS3 capacity levels and competitive carriers are rarely able to find alternatives to BOC last mile facilities to most customer locations. Therefore, in response to the Commission's inquiry in the Public Notice, there have been no significant changes in supply or demand market characteristics that could lead to a conclusion that BOCs do not possess bottleneck control over last mile connections to customers. This permits BOCs to extract unreasonable prices and other terms and conditions from customers that must be addressed by reform of special access rules.

E. BOCs Have Not Offered Viable Commercial Agreements for Loops and Transport

Facilities-based competition is no more effective at counterbalancing the BOC's monopoly power over special access than it was in 2005. It has not prompted the BOCs to offer commercially reasonable alternatives to their standard DS1 and DS3 special access service offerings. Even with their § 271 obligation to offer loop and transport network elements, as explained below, the BOCs refuse to offer anything but their special access services. In fact and

[80] *Omaha Forbearance Order*, ¶ 67.

as discussed below, they are aggressively trying to avoid state commission investigations as to whether their special access offerings are commercially reasonable under § 271. Consequently, many CLECs are withdrawing or are planning to withdraw from service areas where BOCs have been or may be granted forbearance from their § 251(c)(3) loop and transport unbundling obligations because the BOCs' excessive special access prices prevent CLECs from offering competitive local exchange services.

1. The BOCs' Obligation to Offer Section 271 Network Elements Under the Section 201 Just and Reasonable Standard has Not Prompted Them to Offer Rates that are Better than Their Special Access Offerings

In the *TRO*, the Commission held "the requirements of section 271(c)(2)(B) establish an independent obligation for BOCs to provide access to loops, switching, transport, and signaling regardless of any unbundling analysis under section 251"[81] and that these facilities must be "priced on a just, reasonable and not unreasonably discriminatory basis – the standards set forth in sections 201 and 202."[82] The BOCs are seeking to render this obligation meaningless by vigorously opposing state commission efforts to examine or prescribe rates for their Section 271 offerings, generally in the context of § 252 arbitration or tariff proceedings.[83]

For instance, the Maine Public Utilities Commission ("ME PUC") ordered Verizon to file a wholesale tariff that included all of Verizon's wholesale obligations, both those under § 271 as

[81] *TRO*, ¶ 653.

[82] *TRO*, ¶ 656.

[83] BOCs generally argue, *inter alia*, that only the FCC has this authority and in doing so, has avoided state commission review of § 271 obligations in most instances and where they have not, they are aggressively appealing the state commission decisions. *See* Attachment 5 for a list of various state commission decisions in the Northeast discussing Section 271 where Verizon has litigated or still litigating this issue.

well as those under § 251 of the Act;[84] however, the tariff Verizon later proposed did not include rates for § 271 elements. Because of this, the ME PUC issued decisions in 2004 and 2005 that required Verizon to continue providing § 271 elements at TELRIC rates as a temporary measure until Verizon filed a tariff proposing rates that the ME PUC determined were just and reasonable.[85] Verizon refused to accept the ME PUC's decisions and appealed them to the United States District Court for the District of Maine, claiming that the ME PUC lacked authority to set rates for § 271 elements and that the ME PUC's decision to require TELRIC rates was preempted.[86] The Court denied Verizon's motion for a preliminary injunction,[87] and later granted the ME PUC's motion for summary judgment, holding that the ME PUC could lawfully set rates for § 271 elements and was not preempted from ordering the provision of § 271 elements at TELRIC rates on a temporary basis.[88] Unwilling to yield to the Court's decision,

[84] The ME PUC issued these orders because Verizon had previously promised to make this tariff available in return for the ME PUC's support of Verizon's FCC application to enter the InterLATA long distance market in Maine.

[85] *Verizon-Maine Proposed Schedules, Terms, Conditions and Rates for Unbundled Network Elements and Interconnection (PUC 20) and Resold Services (PUC 21)*, Docket No. 2002-682, Order Part II at 12-15 & 21, 2004 Me. PUC LEXIS 291, at *25-32 & *44-45 (Me. P.U.C. Sep. 3, 2004), Order at 6, 2005 Me. PUC LEXIS 74, at *24 (Me. P.U.C. Mar. 17, 2005), Order at 19-21, 23-24, 30, 33, 38, 40, 43-44, 2005 Me. PUC LEXIS 267, at *46-47, *49-51, *57-58, *72-73, *78-79, *80-81, *90-91, *92-93, *96-97, *103-106 (Me. P.U.C. Sep. 13, 2005); *aff'd, Verizon New England Inc. v. Maine Pub. Utils. Comm'n*, 441 F. Supp. 2d 147 (D. Me. July 18, 2006), *appeal pending, Verizon New England Inc. v. Maine Pub. Utils. Comm'n*, No. 06-2151, (1st Cir. filed Jul. 19, 2006).

[86] In its appeal, Verizon also asserted that the ME PUC erroneously interpreted § 271 checklist item 4 and 5 by requiring Verizon to provide access to line sharing, entrance facilities and dark fiber loops and transport.

[87] *See Verizon New England Inc. v. Maine Pub. Utils. Comm'n*, 403 F. Supp. 2d 96, 108 (D. Me. 2005).

[88] *See* 441 F. Supp. 2d at 152-153, 158.

Verizon continued its relentless legal challenge, appealing to the United States Court of Appeals to the First Circuit, where the case is currently pending.[89]

The BOCs vigorously dispute state commission authority to establish § 271 rates and contend that their special access offerings satisfy their § 271 obligations.[90] The last thing they want is to have their special access rates scrutinized by state commissions and potentially found

[89] The New Hampshire Public Utilities Commission ("NH PUC") also held in a number of decisions that Verizon must offer certain 271 elements at TELRIC or at the FCC's prescribed transitional rates until such time as new rates are established and approved by the NH PUC. Verizon challenged these decisions and the appeal is now pending before the First Circuit as well. *See Proposed Revisions to Tariff NHPUC No. 84 (Statement of Generally Available Terms and Conditions); Petition for Declaratory Order re Line Sharing)*, Docket Nos. DT 03-201 and 04-176 (consolidated), Order No. 24,442, Order Following Brief at 41-50, 2005 N.H. PUC LEXIS 24, at *61-75 (N.H. P.U.C. Mar. 11, 2005) and *Verizon New Hampshire Wire Center Investigation, Verizon New Hampshire Revisions to Tariff 84*, DT 05-083 and DT 06-012 (consolidated), Order No. 24, 598, Order Classifying Wire Centers and Addressing Related Matters at 46, 2006 N.H. PUC LEXIS 23, at *74 (N.H. P.U.C. Mar. 10, 2006) *rev'd in part, Verizon New England, Inc. v. N.H. Pub. Utils. Comm'n*, No. 05-CV-94-PB, 2006 U.S. Dist. LEXIS 59339 (D. N.H. 2006), *appeal pending, New Hampshire Public Utilities Comm'n v. Verizon New England, Inc.*, No. 06-2429 (1st Cir. filed Sep. 21, 2006). AT&T and Qwest are also challenging state commission decisions seeking to establish § 271 rates as well. *See, e.g., Southwestern Bell Telephone, L.P., d/b/a SBC Missouri's Petition for Compulsory Arbitration of Unresolved Issues for a Successor Interconnection Agreement to the Missouri 271 Agreement*, Case No. TO-2005-0336, Arbitration Order, 2005 Mo. PSC LEXIS 963 (Mo. P.S.C. July 11, 2005), *rev'd in part SBC Missouri v. Mo. Pub. Serv. Comm'n, et al.*, No. 04:05-CV-1254 CAS (E.D. Mo. Sep. 14, 2006), *appeal pending*, No. 06-3726 (8th Cir. filed Oct. 17, 2006); *Petition of DIECA Communications, Inc., dba Covad Communications Company for Arbitration of an Interconnection Agreement with Qwest Corporation*, Doc. No. T-01051B-04-0425, Decision No. 68440, 2006 Ariz. PUC LEXIS 5 (Ariz. C. C. Feb. 2, 2006), *rev'd in part Qwest Corp. v. Arizona Corp. Comm'n*, No. 2:06-CV-01030-ROS (D. Ariz. July 18, 2007).

[90] *VERIZON-MAINE Proposed Schedules, Terms, Conditions and Rates for Unbundled Network Elements and Interconnection (PUC 20) and Resold Services (PUC 21)*, Docket No. 2002-682, Order at 8 (Me. P.U.C. Oct. 6, 2006) (explaining that Verizon position is that its special access rates were lawfully approved by the FCC and that the FCC has "expressly approved" special access rates as the benchmark for section 271 elements). On Qwest's website under its Commercial Agreements, Qwest directs wholesale customers of DS1 and DS3 loop and transport facilities to its special access tariffs. *See* http://www.qwest.com/wholesale/clecs/commercialagreements.htm (accessed July 30, 2007).

unjust and unreasonable. This scrutiny would provide even more evidence that the Commission's special access pricing rules need to be overhauled so that they produce just and reasonable rates.

2. BOCs' Failure to Make Reasonable Access Offerings Harms Competition

In the Commission's *Omaha Forbearance Order,* Qwest was relieved of its § 251(c)(3) loop and transport unbundling obligations in nine Omaha wire centers.[91] The Order was expressly contingent on a "predictive judgment" that Qwest would provide network elements at just and reasonable rates.[92] As explained in McleodUSA's recent petition, despite McLeodUSA's diligent efforts to negotiate commercially reasonable terms for loop and transport services, Qwest has refused to negotiate and has only made its special access service offering available to replace high capacity Section 251(c)(3) network elements for the affected wire centers.[93] Absent relief from the Commission, McLeodUSA has stated that it will exit the Omaha market because of the dramatic cost increases, which would prevent it from providing competitively priced services.[94]

Integra Telecom, Inc. ("Integra") has also emphasized that it entirely abandoned its plans to enter the Omaha market as a result of the *Omaha Forbearance Order.*[95] It found that it was

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[91] *Omaha Forbearance Order*, n.155.

[92] *Omaha Forbearance Order*, ¶ 79.

[93] Petition to Modify of McLeodUSA Telecommunications Services, Inc., WC Doc. No. 04-223, at 4 (filed July 23, 2007).

[94] Petition to Modify of McLeodUSA Telecommunications Services, Inc., WC Doc. No. 04-223, at 14 (filed July 23, 2007).

[95] Comments of Integra Telecom, Inc., WC Docket No. 06-172, at 5 (filed March 5, 2007) ("The Commission's 'predictive judgment' that the ILEC will have an incentive to offer wholesale facilities at reasonable rates to its competitors has proven to be flawed in Omaha. The

substantially less attractive economically to enter the Omaha market without access to unbundled network elements at TELRIC rates "in the entire Omaha market" and decided that "the investments it was prepared to make to provide service in the Omaha market would be better" utilized in other markets.[96] It emphasized the infeasibility of Omaha market entry via deployment at special access rates, noting that it would be extremely difficult for a CLEC to serve small and medium business customers in competition with the ILEC if loops and transport were priced at special access rates.[97] In the Verizon forbearance proceeding, for similar reasons, Cavalier, One, Cbeyond and other carriers also emphasized that they would not be able to continue operations and serve their customers in the MSAs at issue if Verizon was granted forbearance from its 251(c)(3) loop and transport unbundling obligations and CLECs were forced to rely on Verizon's special access facilities.[98]

Thus, the absence of reasonable terms and conditions of access to BOC last mile connections will harm competition that, in turn, will harm customers through reduced choices of prices and service offerings.

III. THE GAO REPORT VALIDATES CLEC CONCERNS

The GAO Report, issued in November of 2006, investigated the BOCs' special access services. Its findings further demonstrate that the Commission's deregulatory special access

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prediction "that Qwest will not react to our decision here by curtailing wholesale access to its analog, DS0, DS1, or DS2-capacity facilities turned out to be wrong").

[96] *Id.* at 4.

[97] *Id.* at 5.

[98] Comments of Time Warner Telecom Inc., et al., WC Doc. No. 06-192, at 21 & 23-26; Opposition of Cavalier Telephone Subsidiaries to Verizon's Petitions for Forbearance, WC Doc. No. 06-172, at 9, Declaration of JimVermeulen, ¶¶ 8-12 (filed Mar. 5, 2007)

pricing regime has failed. In addition, the GAO Report validated the shortcomings that prompted legacy AT&T to file its Petition for Rulemaking in October of 2002, as well as more recent comments filed by other special access purchasers since then in this proceeding.

As a preliminary matter, the GAO Report recognized that the promotion of competition is a key policy objective of the 1996 Act.[99] It emphasized that "[t]he stated outcomes of this policy objective are to lower prices and increase the quality of telecommunications services available to American telecommunications consumers as well as promote the rapid deployment of new telecommunications technologies."[100] While the GAO acknowledged that the FCC is responsible for making these policy objectives a reality,[101] the GAO did not conclude that the FCC was doing so or otherwise satisfying the Act's objectives.

The GAO Report reveals why the Act's pro-competitive objectives are not becoming a reality, especially as to special access services. *First*, the GAO found that facilities-based competition to end users does not appear to be extensive and that competitive alternatives exist in a "relatively small subset of buildings."[102] It examined 16 major metropolitan areas and found that "competitors are serving, on average, less than 6 percent of the buildings with at least a DS-1 level of demand" and that in "buildings identified as likely having companies with a DS-3 level of demand, competitors have a fiber-based presence in about 15 percent of buildings on average."[103] For buildings with 2 DS-3s of demand, it found that competitors have a fiber-based

[99] GAO Report at 37.

[100] GAO Report at 37.

[101] *Id.* at 37.

[102] *Id.* at 12 & 19.

[103] *Id.* at 12.

presence in only 24 percent of these buildings on average.[104] Based on the data analyzed, it found that competitive Phase II areas generally have a lower percentage of lit buildings than Phase I areas, indicating that the "*FCC's competitive triggers may not accurately predict competition at the building level.*"[105]

Moreover, the GAO's data showed that there has been a *decline* in some MSAs in the level of competitive collocation in the wire centers used by the price-cap incumbents to obtain pricing flexibility.[106] It noted that "[l]imited competitive build out in these MSAs could be caused by a variety of entry barriers, including zoning restrictions, or difficulties in obtaining access to buildings from building owners that discourage competitors from extending their networks."[107] In addition, it found that "where demand for dedicated access is relatively small, such as buildings with less than three or four DS-1s of demand, it is unlikely to be economically viable for competitors to extend their networks to the end user."[108]

Second, the GAO concluded that prices for special access services in MSAs with Phase II pricing flexibility are on average higher than prices elsewhere.[109] The GAO found that since the FCC first began granting pricing flexibility in 2001, "prices and revenue are higher on average for circuit components in areas under Phase II flexibility (areas where competitive forces are

[104] *Id.*.

[105] GAO Report at 12-13 (emphasis added).

[106] *Id.* at 13.

[107] *Id.*

[108] *Id.*

[109] GAO Report at 13 & 27.

presumed to be greatest) than in areas under Phase I flexibility or under price caps."[110] In fact, its comparison of 1,152 prices for channel terminations and dedicated transport for both monthly and multiyear terms revealed that price-flex list prices "were almost always higher than price-cap list prices."[111] This determination was consistent with its finding that "as of 2005, average revenue for channel terminations is higher, on average, in phase II areas than in phase I areas or price-cap areas."[112] More recently, its comparison found that that, "as of June 2006, the price-flex list price was on average higher than the price-cap price, regardless of whether the price was for channel terminations, interoffice mileage, DS-1 or DS-3 service, different term arrangements, or different density zones."[113]

Its research also showed that "price-flex prices as of June 2006 are higher on average than list prices in effect just prior to FCC granting pricing flexibility."[114] The GAO even noted that while the FCC expected price increases in some areas, and these increases would likely be in areas where costs were higher (in which regulation had pushed prices below costs), this was not happening. Rather, "prices increased on average, regardless of density zone or any other parameters."[115]

Third, the GAO found that the effects of Phase I and Phase II pricing flexibility contracts on prices serve to impede rather than promote competition. The GAO explained that these

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[110] *Id.* at 27.

[111] *Id.*.

[112] *Id.* at 28.

[113] GAO Report at 28.

[114] *Id.* at 28.

[115] *Id.* at 28.

"conditions and terms may inhibit switching circuits to competitors" and emphasized that "[c]ustomers who sign contracts may need to meet various conditions, which competitors argue limit customers' ability to choose another provider."[116] It found that "[t]hese conditions include such things as revenue guarantees, requirements for shifting business away from competitors, and severe termination penalties" and that "these types of contracts may inhibit choosing competitive alternatives because the customer does not receive the applicable discount, credit, or incentive if the revenue targets are not met and additional penalties may also apply."[117] The GAO further concluded that "[u]nless a competitor can meet the customer's entire demand, the customer has an incentive to stay with the incumbent and to purchase additional circuits from the incumbent, rather than switch to a competitor or purchase a portion of their demand from a competitor—even if the competitor is less expensive."[118]

Given the above, the GAO criticized the deregulatory actions and access charge reforms the FCC took, in an effort to fulfill the intent of the 1996 Act that involved allowing market forces and competition to govern prices for dedicated access.[119] It recognized that "[a]t the heart of the FCC's actions was a vision of facilities-based competition, where competitors would compete with the incumbents mainly using their own networks and facilities" and that "[u]nder facilities-based competition, incumbents would be constrained from pursuing predatory and exclusionary pricing practices, and prices would be driven toward marginal costs."[120] The Report

[116] *Id.* at 30.

[117] *Id.* at 30.

[118] GAO Report at 30.

[119] *Id.* at 41-42.

[120] *Id.* at 41-42.

also acknowledged the "FCC's deregulatory actions were predicated on proxy measures that [the] FCC predicted would indicate whether sufficient facilities-based competition existed for dedicated access services in order for market forces to function in this way."[121] GAO Report's analysis of "facilities-based competition suggests that FCC's predictive judgment — that MSAs with pricing flexibility have sufficient competition — may not have been borne out."[122] Its report stressed that "[e]ven more troublesome is the fact that some of our analysis, which is based on FCC's competition metrics, suggests that competitive alternatives for dedicated access have declined in some MSAs in the past few years and noted that "[t]he effect that such changes may be having on consumers of all sizes, including the federal government, could be significant."[123]

GAO's findings confirm that the issues that special access purchasers raised in 2005 remain valid and that significant regulatory reforms are warranted. Indeed, the Commission's prediction that adequate competitive alternatives exist to constrain price cap ILECs' anticompetitive pricing of special access has proven incorrect and the lack of competition leaves these ILECs free to increase rates significantly when freed from price cap regulation. This evidence combined with the existing record offers far more than the substantial evidence the FCC would otherwise need to justify re-initialization of special access prices and reform the special access pricing rules as proposed herein.

[121] *Id.* at 42.

[122] *Id.* at 42.

[123] GAO Report at 42.

IV. REFORM OF SPECIAL ACCESS RULES IS NECESSARY TO ASSURE REASONABLE RATES AND CONDITIONS

A. Comparing Special Access Rates to UNE Rates is Appropriate and Demonstrates Special Access Rates are Unreasonable and Need to be Reinitialized to Competitive Levels

In its Notice, the Commission requested comment on how to assess the reasonableness of rates for special access services. The Commission previously stated that it expected that by now it would "have additional regulatory tools by which to assess the reasonableness of access charges."[124] For instance, the Commission stressed that it may "establish benchmarks based on prices for the interstate access services for which competition has emerged, and use prices actually charged in competitive markets to set rates for non-competitive services or markets."[125] Another approach is to use DS1 and DS3 UNE loop and transport rates as benchmarks. Comparing these UNE rates with the functionally equivalent special access rates is abundantly appropriate because both services are provided over the same facilities; however, UNE prices are set at the forward-looking, economic levels reflective of a competitive marketplace. Accordingly, UNE prices provide an excellent benchmark by which to assess whether the BOCs' special access prices are at such levels and, therefore, just and reasonable.[126]

The rate comparisons presented in comments filed in 2005 by a wide variety of special access purchasers reveal that UNE rates do approximate competitive prices.[127] Indeed, in the

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[124] *Access Charge Reform Order*, ¶ 268.

[125] *Id.*, ¶ 268.

[126] *See Access Charge Reform Order*, ¶¶ 267-68 (explaining that by February 8, 2001, it expects to have "additional regulatory tools by which to assess the reasonableness of access charges").

[127] *See* Joint CLECs 7/29/05 Reply Comments, at 10.

limited circumstances where the marketplace is truly competitive, record evidence reveals that the competitors' rates are comparable to, if not less than, UNE rates.[128] Thus, to the extent the Commission does not have competitors' rates against which to evaluate BOC rates, it can confidently rely on UNE benchmark comparisons.[129]

A comparison of special access rates with UNE rates proves that that special access rates far exceed forward-looking economic costs and are therefore unreasonable.[130] For example, based on a sample of Qwest states, for a one-year term Zone 1 DS1 circuit with two channel terminations and 10 miles of channel mileage, Qwest's pricing flexibility and price cap rates are 87% and 169% greater, respectively, than the average of UNEs rates offered in Arizona, Minnesota, Colorado, Washington, and Iowa.[131] The BOCs' ability to charge special access rates that are multiples of their forward-looking costs is glaring evidence that their special access services are not subject to meaningful competitive discipline as the Commission had otherwise hoped. Thus, given the wide disparity between UNE prices and special access prices, even where pricing flexibility has been granted, it is clear that special access prices grossly exceed the

[128] *Id.*

[129] In addition, the United States Supreme Court found that the TELRIC forward-looking cost estimation upon which UNE rates are derived is a fully valid and compensatory method of calculating a Bells true costs. *See Verizon Communications, Inc. v. FCC*, 535 U.S. 467, 467-472 (2002). In fact, TELRIC is overly compensatory given that costs must be calculated on the basis of existing wire center locations and given an inevitable regulatory lag in TELRIC price adjustments. *See id.* at 469-470. BOCs have been unable to identify a single instance in which state-adjudicated, cost-based rates for high capacity facilities depart substantially from the BOCs' costs. *See* Worldcom Comments, RM-10593, at 11 (filed Jan. 23, 2003). Nor have they identified any high-capacity UNE rates that fail to include an allocation of common costs. *Id.*

[130] *See* Declaration of M. Joseph Stith (executed Sep. 30, 2004) (filed in RM-10593 Dec. 7, 2004), Attachments 1 & 2 (Comparison Summary of 3-year, 10 & 0 mile Stand Alone Circuits Price Cap-Pricing Flexibility-UNE Rates)

[131] *See* Attachment 4.